Internal Revenue Service
memorandum

CC:TL-N-9524-89
VLDraper

date: NOV 2 ? 1989

to: District Counsel, St.Louis CC:STL
Attention Don Wells

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This memorandum is in response to your memorandum dated August 22, 1989, requesting tax litigation advice on the issues stated below.

ISSUE

Whether the costs of providing installation, preparation and fabrication services are includable in total contract price used in calculating deferred gross profit from installment sales pursuant to the provisions of I.R.C. § 453 and 453A. 0453-1000

CONCLUSION

We recommend, assuming that [redacted] agrees to a "no change" in its current method of inventorying the costs of installation, preparation and fabrication services rendered in connection with the sale of personal property, that the Government concede the issue raised in your request for tax litigation advice. In the event [redacted] is unwilling to agree to such a "no change," then we currently recommend that the Government pursue both the position raised in your request that installation and fabrication service charges are not incidental charges includable in the total contract price under section 453 (now section 453A), and alternatively, the position of the Service in Marcor, Inc. and Subs. v. Commissioner, 89 T.C. 181 (1987), that the costs of providing installation, preparation and fabrication services are inventoriable costs. The issue of whether to appeal Marcor is presently being coordinated within the National Office. Should the Service decide not to appeal the case, we will notify you of this development. The following discussion is relevant in the event [redacted] does not agree to a "no change."

FACTS

[redacted] ("[redacted]") is a dealer in personal property, selling general merchandise at retail [redacted]. [redacted] reports gross income from installment credit sales pursuant to section 453A.

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Some of the merchandise sold by [redacted] requires installation, e.g., plumbing and heating fixtures, carpeting and other floor covering, fencing, kitchen cabinets and appliances, and building/roofing materials. Additionally, some of the merchandise necessitates fabrication, e.g., draperies and wallcoverings. The fees for these services are added to the cost of the merchandise and, for non cash sales, are collected as installment sales. The charges for these services are separately stated, and for the most part, [redacted] "contracts out" the services through arrangements with independent contractors.

In [redacted], [redacted] adopted the installment method of accounting for sales of personal property under section 453. Although originally excluding the installation and fabrication costs associated with service sales from the cost of goods sold, [redacted] agreed to a proposed Service adjustment to include such costs in the cost of goods sold. [redacted] consistently followed this procedure until the repeal of the installment method of accounting in [redacted].

During the examination of taxable years ended [redacted], [redacted] and [redacted], the examining agent proposed an adjustment to deferred gross profit related to the treatment of California state sales tax. In response to this proposed adjustment, the taxpayer questioned the propriety of including the cost of installation and fabrication services in the cost of goods sold, referring to Marcor, 89 T.C. 181. The agent obtained a memorandum from the Tax Litigation Division which had been sent to the field to suggest an alternative tactic in the Marcor case when the opinion went against the Service in the motions for partial summary judgment. (See attached). This memorandum suggested that the Service argue that separately stated service charges are not "incidental" costs of merchandise includable in the total contract price in calculating the gross profit ratio. Based on this memorandum, the agent in [redacted] proposed the adjustment, the substance of which is to remove the costs associated with installation and fabrication service charges from the cost of goods sold figure used in the calculation of gross profit and to likewise remove from total contract price the installation and fabrication service charges.

DISCUSSION

Section 263A(a), enacted under the Tax Reform Act of 1986, provides for the capitalization and inclusion in inventory costs of certain expenses. Section 263A(a)(2) provides that the costs which must be capitalized are the direct costs of such property and the proper share of indirect costs allocable to such property.

Section 263A(b) provides that the section applies to property produced by the taxpayer. Section 263A(g)(1) defines production as including construction, building, installing, manufacturing, developing or improving. Section 263A(g)(2) provides that the taxpayer shall be treated as producing any property produced for the taxpayer under a contract with the taxpayer.

Section 453 (now section 453A), the installment method for dealers in personal property, allows a dealer in personal property to defer income recognition on installment sales. Treas. Reg. § 1.453-1(a)(1). Treas. Reg. § 1.453-1(b)(1) provides that the taxpayer may return as income each year only that portion of the installment payments actually received which the gross profit to be realized from the transaction bears to the total contract price. This regulation provides that for dealers in personal property, gross profit means sales less cost of goods sold. Thus, for dealers, Treas. Reg. §§ 1.453-1(a)(1) and 1.453-2(c)(1) provide that the percentage of income returned for dealers in personal property is calculated by dividing total contract price over cost of goods sold by the total contract price. Treas. Reg. § 1.453-2(c)(2) provides that total contract price is the total selling price.

Treas. Reg. § 1.453-2(d)(6)(iv) provides that charges for services are nonpersonal property sales unless such services are "incidental to and rendered contemporaneously with the sale of personal property." In this case, such charges can be considered part of the selling price of the property.

Section 471 provides the general rule for inventories. Treas. Reg. § 1.471-3(b) provides the rules for the valuation of inventories at cost.

> "Cost means:
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> (a) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.
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> (b) In the case of merchandise purchased since the beginning of the taxable year, the invoices price less trade or other discounts....To this net invoice price should be added transportation and other necessary charges incurred in acquiring possession of the goods.
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> (c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in

> connection with the product, (2) expenditures for direct labor, and (3) indirect Production costs incident to and necessary for the production of the particular article, including in such indirect production costs an appropriate portion of management expenses, but not including any cost of selling or return on capital....

Treas. Reg. § 1.471-11 provides the rules for the inclusion or exclusion of costs in a manufacturer's inventory. Treas. Reg. § 1.471-11(b)(2)(i) defines direct production costs as those costs incident to and necessary for production or manufacturing operations or processes which are components of the cost of either direct material or direct labor. Direct material costs are those costs and which become an integral part of the specific product and those materials which are consumed in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product. Direct labor costs include the cost of labor which can be identified or associated with particular units or groups of units of a specific product. Treas. Reg. § 1.471-11(b)(2)(ii) provides that a taxpayer must take all direct production cost into his inventoriable costs.

Treas. Reg. § 1.471-11(b)(3) provides that indirect production costs are those costs incident to and necessaary for production or manfacturing operations or processes other than direct production costs. Treas. Reg. § 1.471-11(c) provides that some indirect production costs must be included in inventoriable costs; some are not to be so included, e.g., marketing expenses, advertising expenses, selling expenses; and a third category of costs which are included in inventoriable costs or not depending on the treatment of such costs by the taxpayer for financial reporting purposes.

The issue raised in your request for tax litigation advice involves determining the correct interpretation of Treas. Reg. § 1.453-2(d)(6)(iv). The issues, which were not briefed in Marcor, are whether separately stated service changes associated with the sale of personal property are "incidental" to the sale and whether such services are rendered contemporaneously with the sale. Both requirements must be met in order to include the cost of the services in the gross contract price.

Treas. Reg. § 1.453-2(d)(6)(iv), in determing which costs are included in the contract price for purposes of determing income deferral under section 453, provides:

> The term "nonpersonal property sales" means all sales which are not sales of personal

> property made by the taxpayer....Likewise, charges for services rendered by the taxpayer are nonpersonal property sales unless such services are incidental to and rendered contemporaneously with the sale of personal property, in which case such charges shall be considered as constituting part of the selling price of such property.

The Service position is that many of the services at issue are rendered neither incidental to nor contemporaneous with the sale of personal property.[1] When the cost of the installation of an item approaches the cost of the item, the cost is not an "incidental" expense as that term was intended by the regulation. To interpret the term otherwise prevents the matching of costs and revenues and prevents the clear reflection of income.

"Incidental" is defined in Webster's Ninth New Collegiate Dictionary as "something dependent upon or subordinate to something else of greater or principal importance...an accompaning minor occurrence or condition, occuring ...as a minor consequence or accompaniment...being likely to ensue as a chance or minor consequence...." In this connection the position the Service would take that only costs which are not separately stated in the price of a good are "incidental."

Section 446 provides the general rule for permissible methods of accounting. The guiding rule for determining whether a method of accounting is permissible is whether the method clearly reflects income. One court defined "income" as "a net or resultant determined by matching revenues with related expenses." Mooney Aircraft, Inc. v. United States, 420 F. 2d 400, 402 (5th Cir. 1970). Given this definition, one fundamental requirement for a method of accounting to clearly reflect income is whether there is a matching within the accounting period of income and expenses. See Commissioner v. Idaho Power Co., 418 U.S. 1, 11 (1974); American Automobile Association v. United States, 367 U.S. 687, 692 (1961). An example of this is reflected in Treas. Reg. § 1.446-1(a)(4) which lists the "essential features" of any permissible accounting record. These are maintenance of inventories when required and capitalization of assets and of expenditures related to the assets which extend the useful life of the asset. The fundamental principle of these "essential features" is the fact that they will result in the matching of income and expenses.

A further example illustrating the fundamental requirement

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[1] In particular, we are not here addressing such minor service items as nonseparately stated charges for automobile battery installation.

of the matching concept is shown in the evolution in the use of the accrual method of accounting. "The purpose of 'accrual' accounting in the taxation context is to try to alleviate th[]e problem [of a business transaction spread over two or more years] by matching, in the same taxable year, revenues with expenses incurred in producing those revenues." Mooney Aircraft, 420 F.2d at 403.

Section 453 is a special rule to allow for the deferral of income recognition from the sales of personal property when the property is sold on an installment or revolving sales basis. As an administrative accommodation to taxpayers, the regulations allow incidental revenues from the sales of nonpersonal property to also be deferred. In interpreting the meaning of the term, "incidental," however, it is necessary to always keep in mind that the aim of accounting is to clearly reflect income by not distorting the matching of income and associated expenditures.

The issue then, is at what point the revenue from the nonpersonal property sales contemporaneous with the sale of personal property ceases to be "incidental." Clearly, in those cases where the nonpersonal property revenue approaches the cost of the personal property, the costs could not be considered "incidental" as intended by the regulation. Furthermore, when the services are significant to be contracted out to third parties, they would not seem to be incidental. But whether the services are contracted out cannot be the distinguishing criterion to determine whether the costs are "incidental" as many significant services are also performed by in-house employees. Consequently, we suggest that the Service position be that revenues from the sales of nonpersonal property cease to be "incidental" when they are a significant enough item to be separately stated in the contract price.

Additionally, the Service should argue, if the facts support the position, that the many of the services at issue are not rendered contemporaneously with the sale of personal property as the term "contemporaneous" is intended in the regulation. For example, if the sale of carpeting occurs at one time but the installation services is not provided for several weeks, then the rendering of the services is not contemporaneous with the sale of the personal property. Hence, the income from such services is not covered by Treas. Reg. § 1.453-2(d)(6)(iv).

If the court does not hold for the Service on this first issue, then we recommend arguing that [redacted] is a manufacturer of some of the merchandise it sells by virtue of its provision of installation, preparation and fabrication services and that the expenses associated with these services are includable in the cost of goods sold. In Marcor, an opinion resulting from cross motions for summary judgment, the court categorized the taxpayer as a pure retailer and the expenses at issue as selling expenses.

consequently, the court held that such expenses are not includable in the cost of goods sold.

In Marcor, Montgomery Ward (Ward), a subsidiary of Marcor, is a dealer in personal property under Treas. Reg. § 1.453-2(c)(1), selling general merchandise at retail through mail order catalogs and department stores. Ward is an accrual basis taxpayer who reports its gross income from installment credit sales pursuant to the provisions of section 453. Approximately 54 percent of Ward's sales were on credit, primarily revolving credits.

Some of the merchandise Ward sells requires installation (e.g., draperies), preparation (e.g., unpacking, bicycle assembly) and alteration (e.g., clothing). Ward provides services to generate earnings, to increase sales of merchandise to its customers and to improve service to its customers. Ward charges fees for installation and for some of the preparation services, which fees are stated separately from the purchase price. Approximately 75 percent of installation costs attributable to nonautomotive departments were payments to outside contractors. For purposes of calculating the gross profit ratio under the installment method, Ward includes installation charges in the total "contract price" as defined in Treas. Reg. § 1.453-2(c)(2). Preparation charges, however, are not included in the contract price. The Service did not question the propriety of including installation charges in the total contract price.

The expenses for these services included employee payroll, payments to outside contractors and costs for transportation and supplies. Ward deducted these costs as period expenses on its federal income tax returns, hence excluding these expenses from cost of goods sold in computing its gross profit.

In returning income from the sale of personal property, Ward includes the income generated from the installation and alteration of the property in the total contract price. Ward does not include, however, the associated expenses in the cost of goods sold. Rather it deducts these costs as period expenses. This results in deferring the income from the provision of services under the installment method but deducting the expenses in the current year. Thus, the expenses from the sales of services offset current income rather than being appropriately matched against the income from the services which has been deferred under section 453.

The Marcor opinion confirmed the taxpayer's right to account for installment income in this manner, holding that "[i]n general, the expenses incurred in providing installation and merchandise preparation services, rendered incidental to and contemporaneous with the sale of the merchandise, are not inventory costs of a manufacturer includable in cost of goods sold." In so holding, the court made an implicit factual finding that Ward was not a manufacturer based on the finding that installation, preparation and fabricating processes did not change the "essential nature" of the merchandise.[2] Unfortunately, respondent had used "change in essential nature" as the legal standard for determining when a process is considered to be "manufacturing."[3]

The final decision in this case is not expected until the end of 1989. While we believe that the case was wrongly decided, we have not yet decided whether to appeal the case. Some of the major disputes were settled following the loss of the partial motion for summary judgment, which settlement would weaken an appeal. Further, the alternative issue which has been raised in [redacted] of whether the installation and fabrication costs are incidental costs which can be included in the total contract price was not raised in Marcor. Consequently, the Government cannot raise this issue on appeal.

We believe, however, that the court erred in Marcor. First, it made an implicit finding of fact that Ward was a pure retailer. Such a factual finding is inappropriate in a motion for partial summary judgment. Following from this factual

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[2] The court made the above-described finding on the basis of the facts before it. As such, it apparently included such processes ranging from installation of car batteries to the installation of carpet and flooring. The court withheld judgment, pending further fact finding, as to whether such things as kitchen remodeling, drapery fabrication and engine overhaul might be so extensive as to change the "essential nature" of the product. These issues were settled in Appeals.

[3] If the issue is ever before the court again, we recommend a different standard than a "change in the essential nature" of the product be used to determine whether a process is manufacturing. See e.g., Atlantic Richfield Co., TR-31-1180-89 (July 25, 1989) (it is the level of activity or the taxpayer's degree of involvement with the goods that distinguishes manufacturing or processing from wholesaling or retailing); Rev. Rul. 79-339, 1979-2 C.B. 218 (the transformation of already manufactured materials, such as surplus vessels and wrecked autos into more readily marketable scrap materials constitutes a manufacturing activity); Treas. Reg. § 1.472-8(b)(2)(ii) (although a paper manufacturer can sell uncoated paper, and can purchase or sell paper coating without the paper, the paper manufacturer is engaged in a manufacturing or processing activity when it coats the paper); section 263A(g) (production, the costs of which must be inventoried, includes construction, building, installing, manufacturing, developing or improving).

finding, the court erred in holding that expenses incurred in providing installation and merchandise preparation services, rendered incidental to and contemporaneous with the sale of the merchandise, are not inventory costs of a manufacturer includable in cost of goods sold but are selling expenses which may be expensed.

The basic premise of the Marcor decision was that the accounting rules and regulations under section 471 and its regulations are incorporated into the accounting rules of section 453. With this fundamental premise, we are in complete agreement. See e.g., Doubleday & Company, Inc. v. United States, 86 CV 307 (E.D.N.Y. September 12, 1989). We believe, however, that the court read these regulations too narrowly because of its factual findings and hence erred in its holding.

A dealer in personal property may defer income from such sales under the installment method authorized under section 453. The allowable income deferral is determined by applying a certain percentage known as the gross profit ratio to total sales. For dealers in personal property, the gross profit ratio is calculated as total sales less cost of goods sold over the total contract price. The total contract price is the total sales price.

In analyzing the accounting under section 453 to determine Ward's cost of goods sold for purposes of the section 453 calculation, the court too narrowly read the section 471 regulations and only looked as far as those pertaining to retailers and wholesalers because the court had made its factual finding that Ward was a pure retailer. Had the court not so found, we believe that the manufacturing regulations are broad enough to encompass Ward's installation, preparation and alteration activities.

Under section 471, the cost of goods sold is calculated as the sum of the cost of inventory on hand at the beginning of the period plus the cost of inventory purchases during the period less the cost of ending inventory. Treas. Reg. §§ 1.471-3(a); 1.471-3(b). In applying this rule, however, the court only looked to the rules for the inventory of costs of retailers and wholesalers. The court noted that Treas. Reg. § 1.471-3(b) only requires that the costs incurred in acquiring possession of the merchandise are includable in the cost of inventory.

Following through on the basis of its incomplete perspective that Ward was only a retailer, the Marcor court correctly held that installation expenses and merchandise preparation expenses are not costs incurred in acquiring possession of merchandise. Because the court precluded itself from looking at the regulations which apply to manufacturing, the only possible categorization of the costs was as indirect selling and delivering costs. Selling expenses, in accord with the regulations under 471, are deductible in the year incurred.

Respondent's position is that Ward, in connection with its installation, preparation and fabrication services, served as a producer of the merchandise, not merely as a retailer. That is, Ward did not merely retail wood for flooring; rather Ward sold floors which it produced by installing the wood it sold in the home of the buyer. Ward did not merely sell kitchen cabinets; it sold cabinets attached to the walls of the consumer. We are concerned with the "what" the consumer acquired, the nature of the property involved. Under the terms of the purchase contracts where the consumer chose to have the item installed by the petitioner, the consumer is purchasing an installed item, not an uninstalled one. The difference between the merchandise in the store and that installed or fabricated by Ward is a change in the essential nature of the product.

If the court had not found that Ward was a pure retailer, Treas. Reg. §§ 1.471-3(c) and 1.471-11 would apply. The former regulation provides that in the case of merchandise "produced" by a taxpayer since the beginning of the taxable year, cost means costs of materials and supplies, direct labor expenditures and indirect production costs incident to and necessary for the production of the particular article. Treas. Reg. § 1.471-11(b)(1) provides that costs are production costs to the extent they are incident to and necessary for production or manufacturing operations or processes. Treas. Reg. § 1.471-11(b)(2) provides that direct production costs are components of the cost of direct material or direct labor. Direct material costs include the cost of material which becomes an integral part of the specific product ultimately acquired by the consumer and can without any difficulty be identified or associated with particular units of the product. Direct labor costs include the cost of labor which can be identified or associated with particular units or groups of units of a specific product. Treas. Reg. § 1.471-11((b)(2)(ii) requires that a taxpayer account for such costs as inventoriable items.

The costs of Ward's installation, production and fabrication were incident to and necessary for the production of the particular article ultimately acquired by the consumer. The mere fact that the installation, preparation and manufacturing costs occur at the time of the sale does not make them selling costs. It is rather only the last stage of production of the product.

In contrast, selling costs are costs such as advertising, marketing expenses, sales commissions, etc, costs which directly go to promoting product sales. They are costs which have been categorized by Treas. Reg. § 1.471-11 as "indirect production costs," presumably because, unlike direct production costs, such costs cannot be associated with particular units or groups of units of a specific product. The costs at issue are no more selling costs than are the direct labor costs which go into constructing and finishing a garment compared to merely buying the cut out pieces. In short, the court confused apples and oranges.

While not directly on point, there is a line of cases dealing with the investment tax credit which lends authority to respondent's position. Treas. Reg. § 1.48-2(b)(6) specifies that an item is acquired for purposes of claiming the credit when it is reduced to physical possession or control. Where the terms of the contract of purchase indicated that the consumer had purchased an installed machine, the court found that the credit on the parts could not be claimed until the machine was installed. Madison Newspapers v. Commissioner, 47 T.C. 630 (1967), acq. 1975-2 C.B. 2. Thus the taxpayer could claim the credit only when the property was in operating condition even though it had taken possession of the finished parts earlier. See also, Forest City Publishing Co. v. United States, 72-1 U.S.T.C. par. 9143 (N.D. Ohio 1971); LTV Corporation v. Commissioner, 63 T.C. 39 (1974). Similarly, when the terms of the purchase contract indicated that the taxpayer had not purchased an installed machine, the taxpayer could claim the credit upon possession of the parts, uninstalled. Barron Plastic v. Commissioner, 47 T.C. 638 (1967).

The court in Marcor dismissed Madison Newspapers, and presumably the other cases cited above on the weak grounds that the installation of the items involved in the instant case were comparatively simply compared to the machine in Madison Newspapers and incidental to the sale of merchandise that other customers acquired uninstalled at a lower price. This is not a valid basis upon which to distinguish the cases. The courts in the Madison Newspapers line of cases made clear that they would look to the contract to see "what" item was purchased. As is evident from Barron Plastic, the buyers did not always buy the machinery installed. Thus, to rely on the complexity is to beg the question of "what" the consumer purchased. Complexity is not a valid basis on which to distinguish Marcor from the Madison Newspapers line of cases, and the court in Marcor erred in not looking to "what" item was purchased.

On the basis of complexity, the court in Marcor also refused to apply Pope v. Commissioner, T.C. Memo. 1965-211. In this case, the taxpayer built predesigned houses on property owned by the buyer. The issue was whether the taxpayer was a contractor or a dealer in real or personal property eligible for the installment method. The court found that the transactions involved the sale of property. The constructed houses were merely standardized products manufactured on the customers' own lots, and hence were identical to the sale of any standardized product. Pope thus offers further authority for the case where the courts have looked to "what" item was purchased and disregarded that some aspects of the product could be considered "services." Such precedent is not effectively distinguished on the superficial basis of complexity.

The Marcor court relied on three authorities to support its holding. These cases support petitioner's position, albeit weakly, but the court's reasoning is far from compelling. The court cites Van Pickerill and Sons, Inc. v. United States, 445 F.2d 918 (7th Cir. 1971), Heaven Hill Distilleries, Inc. v. United States, 201 Ct. Cl. 423, 476 F.2d 1327 (1973) and Treas. Reg. § 1.471-3(b) as authority for the position that only costs incurred in acquiring possession of the merchandise are includable in the cost of inventory. Both cases involve the storage of liquor and are therefore inapposite to the analysis of whether installation, production and fabrication costs should be inventoried.

The issue addressed Van Pickerill liquor was whether the cost of storage during the aging process was a deductible expense or an inventoriable cost. The court reasoned that while the inventory of unbottled whiskey had some of the characteristics of work in progress, section 471 and its attendant regulations provided the taxpayer with enough flexibility to expense the costs. In particular, the court noted that section 471 provides that taxpayers' accounting methods should conform as nearly as possible to the best method. The court noted that the method used by Van Pickerill was the one most widely used in the industry. Further, the court noted that fact that Treas. Reg. § 1.471-2(b) gives weight to the consistency of use of an accounting method. Van Pickerill had used this method since its inception. While the Van Pickerill case is authority for the Marcor court's holding, the Marcor court inaccurately and perhaps somewhat disingenuously attributed to Van Pickerill the reasoning that as the cost of storing whiskey was not a cost of "acquiring" it, such cost did not represent an inventoriable cost.

Rather the Van Pickerell court made the similar error as the Marcor court: it failed to acknowledge that Van Pickerell in substance contributed to the creation of the product finally sold to the consumer, albeit passively, by merely holding it. At least, however the Van Pickerell court was honest enough to acknowledge that the whiskey had characteristics of work-in-process and that there was authority in the rules for the position argued by the government.

As further authority for the "acquisition" thrust of the court's opinion, the court cited Heaven Hill Distilleries, Inc. v. United States, 201 Ct. Cl. 423, 476 F.2d 1327 (1973), a case also involving the storage costs of whiskey. This court had three reasons why the aging process of whiskey was not manufacturing. None of these reasons apply to the processes involved in Marcor. First the court reasoned that as nothing was done to the whiskey during the storage process, but rather the aging process proceeded naturally, the cost of such storage was not a cost to be included in the inventory. In Marcor, something was done to the product. Second, the court reasoned that the costs involved were intermediate between the manufacturing process and the barreling stage and could belong to either stage. But it found that the costs were more closely identified with the sales phase. In Marcor, the costs were more closely identified with the production phase. The active process of installing, preparing and altering is clearly distinguishable from a passive storage process. Finally, the court, following Van Pickerell, held that in a situation where the correct position could go either way, the court would go with the one consistently followed by the taxpayer. In Ward's case, this may have been true. [redacted], however, has consistently inventoried the cost of the services since [redacted]. Thus, the Marcor court's authority is not compelling in Ward's case and even less so in [redacted] case.

In light of the above analysis, we believe that the position of the Service in Marcor v. Commissioner was correct in that it provides for matching income and expenses. Given this position and the fact that [redacted] has consistently inventoried the service costs since [redacted], we recommend that provided [redacted] is willing to continue accounting for installment sales as it has since [redacted], the Service withdraw its adjustment disallowing the inclusion of income from the installation, preparation and fabrication services in the total contract price for purposes of calculating the section 453 deferral. In the event that [redacted] is not willing to return to the prestatutory notice status quo, we recommend that the Service first take the position disallowing the inclusion of income from the installation, production and fabrication services in the total contract price to the extent that such costs are separately stated to the consumer, and secondarily take the position that the service expenses must be inventoried.

CONCLUSION

We agree with your recommendation that provided [redacted] is willing to continue accounting for the costs associated with installation, preparation and fabrication services by inventorying them, the issue of the exclusion of the revenues from such services from the contract price in the section 453 calculation be conceded. In the event that [redacted] is not willing to return to the status quo, we currently recommend litigating the issue of the exclusion of service revenues from contract price and alternatively the Marcor issue of whether the costs of installation, preparation and fabrication should be inventoried. The issue of whether to appeal Marcor v. Commissioner is currently being coordinated within the National Office. We will inform you should the Service decide not to appeal the case.

If you have any questions, please contact Virginia L. Draper at FTS 566-3521.

MARLENE GROSS
Assistant Chief Counsel

By: Gerald M Horan
GERALD M. HORAN
Senior Technician Reviewer
Branch 1
Tax Litigation Division

Attachment:

Memorandum regarding Marcor v. Commissioner, dated December 17, 1987.